Working Paper Series

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Working Papers Series
Issues in Financial Regulation
Research Department
Federal Reserve Bank of Chicago
April, 1992 (WP-92-5)

FEDERAL RESERVE BANK
OF CHICAGO

March 30, 1992

INCENTIVE CONFLICT IN DEPOSIT-INSTITUTION REGULATION: EVIDENCE FROM AUSTRALIA

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Economic models are collections of hypotheses put together to explain an interesting pattern of repeated behavior. Economists, as other scientists, tailor their models to past data sets and given institutional structures. To broaden the usefulness of a model requires the need to reassess its pertinence in fresh data sets and alternative institutional structures when and as further observations develop. The issue to be tested is the extent to which postulated elements of behavior occur in different circumstances and in different eras.

Building on Jensen and Meckling (1975) and Myers and Majluf (1984), Kane (1989 a and b) offers a formal model of incentive conflict in deposit-institution regulation. This model was

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Both authors visited Australia in 1990 and Kane returned in 1991. Kane's first visit was sponsored by the University of New South Wales and his second by the Reserve Bank of Australia. Kaufman's visit was sponsored by Deakin University, Geelong, Victoria. For criticism and information, the authors thank: Warren Hogan (University of Sydney); Ian Harper (University of Melbourne); Ian Sharpe and Michael Skully (University of New South Wales); Pasquale Sgro (Deakin University); David Collins (Macquarie University); and James Moser (Federal Reserve Bank of Chicago).

designed to explain pre-1990 U.S. failures of federal and state deposit-insurance funds. It incorporates four premises.

First, whether or not an explicit government deposit-insurance system exists whose potential losses are subject to limited liability and formal coverage limits, depositors and deposit-institution managers recognize that the self-interest of government officials creates a conjectural system of implicit coverages that embodies a rational expectation of taxpayer "bailout". Second, the extent of the implicit coverage that is offered to various creditors of failed and failing institutions can be explained by treating politicians' and regulators' perceptions of their career interests as supplementing and conflicting with traditional societal goals in the objective function that economics presumes officials to optimize. These first two premises maintain that managers of regulated institutions and formally uninsured creditors should recognize that regulatory responses would be sensitive to conflicts of interest with taxpayers and to economic incentives established by the implicit and explicit way that politicians and regulators are compensated (Kane, 1989a and b; Boot and Thakor, 1991; Campbell, Chan, and Marion, 1990).

The other two premises explain how a conflict between societal benefits and financial-regulator self-interest damages the taxpayer. The third premise posits a tendency for officials to gamble on postponing needed regulatory action. The fourth explains how this regulatory gambling occurs at taxpayer expense.

Information asymmetries and bureaucratic inertia render politicians and regulators slow to confront emerging shortages of capital at the institutions they regulate. Further, before the economic significance of a given shortage can be grasped, its aggregate size may grow large enough to threaten the reputations and careers of regulators and politicians in charge. In such a case, officials will be strongly tempted to cover up the magnitude of the problem and to delay the painful kinds of action that could resolve the capital shortage. Together and separately, these recognition lags, coverup activities, and repeated acts of procrastination increase the moral hazard that taxpayers face from the operation of government-regulated financial institutions. By subsidizing risk-taking by decapitalized firms, each increases the discounted present value of the bill for cleaning up the mess that taxpayers must pay when the coverup finally falls apart (Barth, Bartholomew, and Bradley, 1990).

The incentive-conflict model was developed from observing the U.S. system of government. The U.S. system makes explicit provision for deposit insurance and makes it hard to pin responsibility for governmental mistakes convincingly onto a single political party. It is important to examine whether and how the model works under different governmental and institutional structures.

This paper concludes that the model explains the sequence of events observed in a 1990 taxpayer bailout accorded a large deposit-institution failure in Australia. In contrast to the U.S., Australia operates under a parliamentary government and does not have a system of explicit deposit insurance.

1. BROAD SEQUENCE OF EVENTS

Australian building societies correspond to U.S. savings and loan associations. In 1990, the Farrow Group of building societies (the largest in the State of Victoria and the second-largest nationwide) was closed by state regulators under politically embarrassing circumstances. Moreover, the closing came at about the same time as the state was already being embarrassed by the failure of the state-owned State Bank of Victoria and its sale at a loss to the federally-owned Commonwealth Bank.

Table 1 presents a summary chronology of the major events in the Farrow debacle. The chronology is organized to clarify that events passed through six stages delineated in the incentive-conflict model. The principal variation from chronologies for the U.S. is that, without an explicit deposit-insurance fund in which to park depositor losses, the depositor bailout and loss-redistribution stages were compressed into a single process.

In large part, Farrow's net-worth deficit reflects the costs of misregulation. Large losses were generated by an aggressive and long-playing strategy of risk taking undertaken by regulated thrift institutions. To protect taxpayer interests, regulators ought to have recognized and controlled the consequences of this strategy long before they did. Cumulative losses could become so large only because the Group's economic insolvency was not reported, resolved, and recapitalized as it developed. Farrow used fancy-footwork accounting to mask its insolvency and to let it convert its operations effectively into a go-for-broke Ponzi (borrow from Peter to pay Paul) growth scheme. Experienced and conscientious regulators from the Victoria Registrar of Building Societies should have seen the same problems that Farrow's accountants identified in the Group's 1986 audit. Being asleep at the wheel or responding to narrow political counterpressures in their own self-interest appear reasonable explanations of the regulators' failure to challenge the rapidly growing firm's Ponzi accounting scheme and its undiversified position in Australia's risky property market. The Farrow institutions paid above-market rates of interest to attract the funding growth the scheme needed to pay existing depositors. To ensure its ability to report revenue growth and pay dividends, Farrow also capitalized the interest payments it was due into many of the riskiest commercial mortgages it was booking so that it was effectively paying itself and delaying potential defaults.

After the institutions in the Farrow family were closed on June 22, 1990 by the State of Victoria, official estimates of Farrow's insolvency were belatedly prepared by an administrator appointed by the Victoria Registrar of Building Societies, Mr. K. J. Russell of the accounting firm of Coopers and Lybrand. On December 7, he released an income statement and balance sheet covering the financial year ending June 30, 1990. His calculations assumed that the societies would not reopen as independent entities and projected that assets would be liquidated in an orderly fashion. These statements show a sharp increase in the provision for doubtful debts and substantial writedowns for bad debts, properties, leases, and investments in subsidiaries. The bottom line is a loss of more than A$500 (U.S. $400) million for 1990. Booking loan fees upfront (rather than as part of a loan's contractual interest rate) and crediting interest on deteriorating loans from capitalized reserves had allowed Farrow to report on after-tax profit of some A$22 million and a net worth of A$160 million for the previous year. The 1990 loss approached the high end of earlier estimates of Farrow's unrealized losses and left the firm roughly A$400 million in the hole.

When the value of its mortgages began to sink sharply in early 1990, depositors ran on the institutions. In response, Farrow used government officials to dissuade depositors and holders of withdrawable shares from running on its large Pyramid subsidiary. Thus, in February, several State of Victoria ministers, in a statement intended to reassure depositors, explicitly denied that the institution faced any serious problem. During the months that followed, Farrow undermined the positions of those that relied on the government's assurances by selling or collateralizing most of its good assets to finance withdrawals requested by the firm's least-gullible accountholders.

It is important to note that the closing of the Farrow societies in June was forced by the market discipline of a rational deposit run and not by regulators' solvency standards. As has happened repeatedly with large troubled institutions in the U.S., regulatory forbearance was ended only by depositors' refusal to believe false or uninformed governmental sweet talk about an underwater firm.

Farrow's June closing was triggered under the Victoria Building Societies Act of 1986 by an unrepaired decline in the associations' liquidity ratio below 7 1/2 percent of liabilities. Reports issued after the closing but before the appointment of the liquidator estimated the Group's losses to be between A$250 and A$570 million dollars. Because even the lower amount greatly exceeded the association's stated capital (including nonwithdrawable share capital) the Group was clearly economically insolvent.

Although the Victoria premier initially voiced his opposition to a taxpayer bailout of depositors at these institutions, the assurances his ministers had issued to depositors left his government politically and litigably vulnerable. On July 3, the State announced a program to "guarantee" the depositors and holders of withdrawable share capital against loss. However, the scheme finally developed repays only the face value of accounts. It does not accrue interest after June 30, 1989 and, for all but the smallest depositors, it stretches the payments over a five-year period without interest.

To assure funding for the payout, the Victoria government imposed an approximately 3 cents per liter gasoline tax. The State imposed this tax even before it had a true picture of the market value of the assets in the institutions, and thus the cost of the bailout. Assigning the proceeds of a tax increase to the bailout is an exercise in accountability that U.S. politicians did not undertake. However, in its other actions, the State faithfully reproduced in the Farrow disaster many prototypical elements of the U.S. S&L mess: Inordinately low capital; risky investments that generated large losses when economic conditions turned down; rapid asset growth; questionably accounting practices shading toward fraud; self-dealing by owners/managers; high deposit interest rates; excessive payouts to managers and stockholders; lax government supervision; delayed recognition of the severity of the problem by regulators; and uninformed or false government/regulator assurances to depositors that deeply troubled associations were solvent. Also, as in most of the more costly insolvencies in the U.S., the Farrow case was characterized by recent changes in ownership, high concentration of ownership, complex corporate structures, efforts by state regulators to win market share from federal competition, and a strong political and community stake in preventing closure.

2. HISTORY OF THE FARROW GROUP

The origins of the Farrow Group date back to 1867 when the Geelong Building Society was organized in the city of Geelong, some 40 miles west of Melbourne. In 1929, Mr. R. G. (Bob) Farrow, the father of Mr. R. W. (Bill) Farrow who became the founder of the Farrow Group, joined the accounting firm of Hendy, Leary & Co., which had been managing the Geelong Society for some years. Bob

Farrow left Hendy, Leary in 1934 and organized a number of housing co-operative societies. In 1959, he organized the Pyramid Building Society in Geelong and managed it through his firm, R. G. Farrow & Co. In 1967, Bill Farrow, joined the firm. In 1971, R. G. Farrow was appointed manager of the Geelong Building Society and Bill Farrow was appointed General Manager and Secretary of both the Pyramid and Geelong Societies. In 1983, the Farrow Company bought the Federation Building Society and, in 1984, the Countrywide Building Society. The collection of building societies and ancillary organizations were renamed the Geelong Building Societies Group in 1986 and placed under the Farrow Corporation Ltd. in 1987. The assets of the Farrow Group expanded from near A$260 million in June 1981 to A$900 million in June 1987 to A$2,900 million at year-end 1989. This represented a tenfold increase in less than 6 years and a twofold increase in the last year and one-half.

Pyramid was by far the largest and fastest-growing member of the Group, acquiring a number of small Victoria building societies and expanding its branch network into Melbourne and throughout the state. Of the A$2.5 billion of assets of the Farrow Group in June 1989, A$1.9 billion, or nearly 80 percent, was booked by the Pyramid Society.

Capital Weakness

The Victoria Building Societies Act of 1986 requires building societies to maintain a capital-to-asset ratio of 2.5 percent, effective January 1, 1989. Capital is defined as permanent share capital and reserves (retained earnings) valued at historical cost.

The Farrow Group reported capital ratios increasing from 0.6 percent in June 1983, to 1.9 percent in 1987, and to 2.5 percent in June 1988. By June 1989, the ratio had declined to 1.8 percent.

Using the Act's definition, capital was even lower at the building societies than at the holding company level. The capital ratio at Pyramid was less than 1 percent on both June 1988 and June 1989. To increase the capital base of the societies, from 1987 on the societies sold non-withdrawable share capital. This is share capital that can only be sold to other buyers and has a lower-priority claim on assets than withdrawable shares or deposits. These shares also carried reduced voting rights (one vote per shareholder, rather than one vote per share) that did not threaten to dilute Bill Farrow's control. During its last years, between 75 and 80 percent of Pyramid's capital base consisted of nonwithdrawable share capital, amounting to 2.7 percent of assets in June 1988 and 4.5 percent of assets in June 1989.

Nonwithdrawable shares were not frequently sold by non-Farrow societies. Farrow tellers sold them to regular deposit customers at teller cages. The tellers were paid a commission on these sales. Despite the fact that at the time of purchase buyers appeared to have been given a prospectus that explained the greater risks involved, the characteristics of the shares did not appear to have been emphasized by the tellers. As in the U.S. Charles Keating/Lincoln S&L case, many buyers of these subordinated instruments claim with a persuasively quivering lip that they had been led to believe that they were buying term deposits and left unaware of the difference until they closely examined their certificates weeks, months, or years later.

Rapid Growth

The assets of the Farrow Group expanded spectacularly, increasing by a factor of 11 in the 6 1/2 years ending year-end 1989 and more than tripled in the firm's final 2 1/2 years. This corresponds to annual compound rates of growth of almost 50 percent for the longer period and 75 percent for the final period. The growth rates would be greater if off-balance sheet guarantees were included. In large measure, this growth was fueled by paying above-market rates on deposits, reportedly some 2 to 4 percentage points above equivalent deposit rates at more conservative institutions. A considerable proportion of the growth was also fueled by borrowing longer-term on a secured basis from banks and other financial institutions. Their collateralized position gave these creditors priority in case of failure and increased the potential loss allocatable to depositors.

Farrow's rapid rate of growth was no secret. Growth was an explicit goal whose achievement was widely publicized by the Group. At the time of its closure, the Farrow Group had become the largest building society in the State of Victoria and the second largest in Australia, although in part because some previously larger societies had converted to banks.

Risky Investments

The Victoria Building Societies Act requires building societies to hold no less than 50 percent of its assets in residential mortgages. The Act also set the maximum loan-to-value ratio on such loans at 75 percent. For other loans, the maximum loan-to-value ratio was set at 66 2/3 percent. A maximum of 6 percent of a society's assets may be in unsecured loans.

An analysis of the Farrow societies at the time of their closure reported that residential mortgage loans totaled only A$300 million. Commercial mortgage loans stood more than seven times as high, at A$2.2 billion. After the failure, the Victoria Attorney-General found that "motels, hotels, and nursing homes" had been classified as residences. Many commercial loans were extended to newer developers building on the Gold Coast area of the State of Queensland, which experienced a strong boom in the late 1980's. The sharp slowing of this boom after 1989 unwound Farrow's growth strategy. Losses on these loans appear to have been large. Many were made in violation of the authorized 66 2/3 percent loan-to-value ratio and in imprudently large multiples of the borrower's net worth. In one case, loans in excess of A$100 million were reportedly made to a client whose net worth was less than A$2 1/2 million. Credit evaluation and underwriting procedures appear to have been weak and many loans capitalized future interest payments. Capitalized interest loans were reported to account for some 25 percent of the societies' loan portfolios. Most of these loans carried large upfront fees. These fees were recognized as immediate income and accounted for a significant percentage of the societies' earnings in recent years.

Questionable Accounting Practices and Fraud

After the February 1990 run, the Farrow Group retained the public accounting firm of Price Waterhouse to assess the future viability of the Group. Submitted in mid-March, the report noted a number of poor accounting practices, criticizing particularly the practice of capitalizing interest and fee payments on commercial loans. This practice served to increase loan-to-value ratios, to delay recognition of any difficulties until the end of the loan term, and to record interest generated from loan proceeds as current income. The societies were booking income on payments that they were conveying to themselves.

In addition, fees were recognized immediately rather than spread over the life of the loan, loans were not booked as nonaccruing until long after the usual 90 days overdue, and overdue amounts of interest and fee payments were not classified as part of bad or doubtful loans.

Price Waterhouse recommended sharp increases in general and specific reserves on commercial loans and a minimum capital injection of A$100 million. It took issue with Farrow's regular auditors on the quality of some parts of their analytical review and criticized their failure to press for higher specific loan loss reserves. Nevertheless, Price Waterhouse concluded that the adjusted value of assets available to depositors on January 31 was sufficient by a narrow margin. It noted, however, that unrecognized losses could force future writedowns and that the 30 percent of creditors that were secured would receive priority in the event of liquidation.

Excessive Payouts

Farrow societies reportedly paid interest rates on deposits between 2 and 4 percentage points above market rates to attract large amounts of funds quickly. The Farrow Group received 2 percent of the societies' assets as management fees and distributed A$11.4 and A$13.4 million to nonwithdrawable shareholders at year-end 1989 and 1988, respectively. Despite Farrow's continuing financial stress, a A$0.4 million dividend was paid to stockholders only days before it was closed in June 1990.

Managerial perquisites were substantial. To house its expanding business, a new headquarters building was constructed in Geelong as described by Farrow on a "prime bayfront site... The classically-designed complex has one six-story office tower and a separate three-story building. It is the largest development of its type in the region. The 8,279-square meter site overlooks Corio Bay, the Royal Geelong Yacht Club, and parkland." The building was completed just in time to be closed and stands unoccupied. In addition, in its last two years the Farrow Corporation spent more than A$6 million to put together a major art collection. Some of the individual pieces were purchased at auctions at prices more than double their presale estimates.

Ineffective Government Supervision

Building societies in Victoria are supervised by the Registrar of Building Societies. Each Society most report selected balance sheet information to the Registrar monthly. During the February

1990 run, the Registrar issued a statement that "ongoing monitoring of the Society has revealed nothing of concern... Building Societies are subject to State legislation which is designed to ensure that depositors' funds are secure."

The Registrar had two employees to monitor the 20-odd societies in Victoria. Upon taking over the Farrow institutions in June, the administrator, relying on the Registrar's reports, promised that he would re-open Pyramid after one week. Unfavorable evidence generated by his office during this single week was enough to convince him that the societies were in far worse shape than the Registrar had recognized and justified a decision to close all Farrow Group institutions permanently.

3. GOVERNMENTAL DENIAL, PRESS CONFUSION AND IMPRUDENT STATEMENTS

In confronting the February and June runs on Farrow institutions, the absence of explicit system of deposit insurance coverage tempted authorities and journalists to make careless statements about the nature and extent of the informal government guarantees inherent in the regulatory process. In turn, the threat of class-action lawsuits against ineffective regulators and framers of careless assurances generated political pressure that helped to transform at least a few rash statements into self-fulfilling prophecies.

In an effort to end the first run, the Treasurer and the Attorney-General of the State of Victoria issued a joint "media release" on February 13 that has been a source of controversy ever since. They asserted that:

> depositors' funds in the Pyramid Building Society are secure. There is no reason for people to withdraw their funds... Rumors circulating about the society are without foundation... Building Societies are subject to State legislation which is designed to ensure that depositors' funds are secure... <u>The Victoria Government will co-operate with all relevant authorities to ensure that depositors' funds are secure.</u> (Italics supplied.)

This statement was ill-advised in two ways. First, because no explicit deposit insurance existed. Whether or not the last sentence of this statement conveys official "insurance" of depositor "security" ought not to have been left unclear. Second, the rest of the passage relies on hollow assurances from state regulators and an unsubstantiated written statement from Pyramid's auditors that there is "absolutely no reason to be concerned that depositors' money is at risk." This assurance was repeated by Bill Farrow three days later in a letter to depositors in which he denied any difficulties and blamed the run on mere rumor.

The failure to espy the solvency problem lurking within Farrow's liquidity problems was not limited to government officials. The <u>Australian Financial Review</u> (Australia's counterpart to the <u>Wall Street Journal</u>) editorialized as late as June 26 that:

> since the beginning of this year, rumors -- and only rumors -- about Farrow's liquidity have circulated and runs on its deposits have ebbed and flowed periodically... The fact that such runs could occur on the basis of mere rumor...

To stop these runs, the editorial concluded that:

> the... government should thus waste no time in guaranteeing depositors' funds, even if (the) administrator... does not regard the lack of such a guarantee as a stumbling block to a successful restoration of trading. ("State Must Accept Some Blame for Farrow." Australian Financial Review. June 26, 1990, p. 16.)

In Australia, the status of implicit guarantees on deposits at either commercial banks or building societies remains fuzzy and confusing (Hogan and Sharpe, 1990 and English, 1991). The Reserve Bank is charged by the Banking Act to protect depositors of commercial banks that under the Act are supervised by the Reserve Bank. But what is meant by "protect" has not been clearly defined.

The Banking Act does require the assets of troubled banks to be made available to meet depositors' claims ahead of the claims of other creditors. The Reserve Bank prefers to be fuzzy about the obligations it would feel if the market value of bank's assets were to fall short of either the par or present value of total deposits. As in the U.S.' "too big to fail" policy, regulators describe this policy as creating "constructive ambiguity". In future insolvencies, depositors might or might not be asked to assume pro rata losses and large depositors might or might not be treated less favorably than small depositors.

Without loss to depositors, the Reserve Bank has managed in recent years to merge a number of troubled small banks into larger and sounder banks. According to the Reserve Bank, these mergers were executed before the troubled banks' economic capital was fully depleted, with no loss accruing to the Bank in the process.

However, depositors at insolvent state-owned banks in the states of Victoria and South Australia have been fully bailed out as the State Governments had guaranteed the deposits. These rescues occurred without a suspension of operations or providing an adequate accounting of the incidence of cumulative losses.

The Reserve Bank explicitly denies any responsibility for resolving insolvencies at state-supervised building societies. Although building societies are not subject to Reserve Bank supervision, their potential failure could fall within the Bank's charge to provide for the "economic prosperity and welfare of the people of Australia." The Reserve Bank's policy on troubled building societies was enunciated by its Governor as follows:

> We are not prepared to provide direct assistance to an institution which we do not supervise. Nor are we prepared to 'lean on' others who might be approached to provide short-term support. We also seek to avoid being drawn into what are essentially commercial judgements about the solvency and future viability of a nonbank institution that is experiencing problems... If a bank, having satisfied itself as to the basic soundness of an institution in difficulty, decides to lend support and finds its own liquidity strained as a result, then it could confidently turn to the Reserve Bank for liquidity assistance (Fraser, 1990).

In late 1991, a parliamentary commission established in the wake of the Farrow failure and other banking debacles recommended that large building societies with assets in excess of one billion dollars obtain banking charters and come directly under the supervision of the Reserve Bank.

The extent of public uncertainty and confusion about potential official support for building societies was broadened rather than narrowed by press coverage of the Farrow Group's demise. On February 19, 1990, just after Victoria ministers had expressed their confidence in the Farrow societies, the Melbourne Age ran an egregiously inaccurate article headlined, "Banking on Safety Nets to Stay Disaster-Free". The author wrongly asserts that:

> ... even if there had been doubt about the Pyramid's solidity, depositors need not have panicked... Building societies, like the two other main savings institutions -- banks and credit unions -- have legislated safety nets designed to protect investors.
>
> Building societies and credit unions have state regulators governing them, while banks are responsible to the federal Reserve Bank. If a bank goes under, depositors have the Reserve Bank to fall back on. State regulators ensure that if a building society or credit union goes under the depositors will get their money back. (Mangan, 1990)

A mid-article headline baldly maintained that "If a building society or credit union goes under, its depositors will get their money back." The author's reassurances were counterbalanced only by the warning that "there are details you should check before putting your money in an institution."

One detail that the article pursued concerns the distinction between depositors and shareholders at building societies. The article claimed that as investors, the latter assume greater risk, and drew no distinction between the risks faced by holders of withdrawable and nonwithdrawable shares. All other sources (including regulators and the trade association) treat withdrawable share capital at building societies as equivalent to deposits. The article goes on to reassure shareholders that protection is provided by the nature of the societies' assets, which are regulated in type, diversified, and monitored monthly and "much more closely than most companies" by the State regulator.

On July 3, 1990, just before the Victoria government announced its guarantee, front-page articles in the Sydney Morning Herald assured depositors at other building societies, particularly those in New South Wales: "Your cash is safe" and "Don't panic, it won't happen here." One article noted that:

> Before the problems with Pyramid it was widely assumed that State governments would always stand behind building societies -- an assumption that has been successfully tested in the past and which has provided an important support for investors... Even if (Victoria Premier) Mr. Cain agrees to a government bail-out, I for one, will never be quite as confident that a building society in trouble automatically will be bailed out by a State government... Fortunately, the chances of this being necessary are significantly lower in NSW than in Victoria since the regulations governing this State's societies are substantially stronger. (Freeman, 1990)

Another article quotes the New South Wales Premier, Mr. Greiner, to the effect that:

> All the State's building societies were safe and that regulations were 'infinitely better, infinitely stronger and there is no risk in NSW.' He also branded the Federal Minister for Finance, Mr. Willis, 'grossly irresponsible' for saying on Sunday that building societies were not as safe as banks. (Skulley et al., 1990)

It took eight months for the Victoria Government to admit that in February it had mistaken a solvency problem for a liquidity problem. In December 1990, two witnesses in a suit Farrow brought to regain control of the societies testified that in February the

Reserve Bank had recommended to Victoria's Premier that the Farrow societies be shut down. (This was not confirmed by the Reserve Bank.)

The Victoria Ministers' February vote of confidence brought Farrow four months of grace and made it dangerous for members of the Victoria Government to forswear a bailout. On July 3, the government announced it would protect the par value of all deposits and withdrawable share capital. As noted earlier and Table 1 clarifies, this did not mean that the government protected either the present value of these positions or all of their accrued interest. Payouts were scheduled without interest on a five-year installment plan starting near year-end with the exact proportions of payments scheduled to vary with the account balance. At that time, all affected depositors were to be given promissory notes for the face amount of their deposit. Progressively larger accounts were to be paid out progressively more slowly. The notes could be sold at a discount to banks. Using consumer interest rates, which ranged from 18 to 20 percent at the time, the present value of large deposits figured to be only 60 to 70 percent of their par amount. Thus, the majority of deposits and withdrawable share capital was protected fully only in nominal amounts, not in present value amounts. Moreover, depositors had only incomplete access for the six months from June to December. The timetable appeared to have been determined without a clear estimate of the liquidation schedule or market value of Farrow assets. To assure its ability to make the promised payments, the government relied on its new tax on petrol.

4. POLICY IMPLICATIONS

The incentive-conflict model developed from U.S. experience performs well in explaining the 1990 behavior of regulators and politicians in the Australian State of Victoria. Adverse economic events (particularly the collapse of real estate markets) help to explain Farrow's initial insolvency, but for the insolvency to grow into a statewide mess required escalating misregulation. Difficult-to-monitor misregulation explains why depositors and shareholders let Farrow's cumulative loss become so large and why Victoria taxpayers and depositors ended up absorbing a bulk of this loss. If elected and appointed officials responsible for supervising Victoria thrifts had been singlemindedly motivated to protect only taxpayer interests, Farrow's bills would not have mounted so high that they could not have been absorbed primarily by the firm's formal stakeholders.

In a representative democracy, unless specifically prohibited, granting regulatory forbearances to economically insolvent deposit institutions protects the career and reputational interests of many elected and appointed officials. Authorities are reluctant to close a troubled firm because closures impact negatively on public perceptions of incumbent performance and because most troubled firms and their constituents find it useful to amass and exercise substantial political influence. Systematic weaknesses prototypically exist in the information, monitoring, enforcement, and incentive systems under which financial regulators operate that make it technically difficult and personally painful for supervisory officials to rein in risk taking by aggressive or undercapitalized institutions.

As Chambers and Wolnizer (1990) emphasize, it is poor public policy to allow deposit institutions to overstate their economic incomes and net worths with impunity by granting them the authority to delay accounting recognition of predictable losses and economic costs. It is difficult to adequately monitor government efforts to manage taxpayer obligations that are not themselves appropriately measured. Distracting smoke and mirrors thrown up by historical cost-based deposit-institution accounting kept nearly all parties, including the financial press, from recognizing Farrow's insolvency and encouraged Victoria officials to issue unfounded and costly reassurances to Farrow's worried depositors.

The absence of an <u>explicit</u> system of deposit insurance did not prevent Victoria taxpayers from providing significant <u>implicit</u> credit enhancements to economically insolvent deposit institutions. Similarly, in the U.S., Ohio, Maryland and Rhode Island taxpayers were not safeguarded by the allegedly <u>private</u> nature of the corporations that insured deposits at state-regulated institutions (Kane, 1991). Indeed, the lack of any explicit insurance fund in Australia may actually have increased taxpayer losses by confusing taxpayers and their governmental agents about the need to monitor and control the government's loss exposure in Farrow operations.

Whether or not government officials openly acknowledge taxpayers' loss exposure, market participants recognize its existence. Whenever a government charters and supervises a set of deposit institutions, government officials are going to be implicated in any losses these supervised institutions develop. To minimize the political damage from such losses, politicians (such as Victoria Premier John Cain) retain a clear and well-understood option that is exercisable at any time before or after taking over an insolvent banking firm. This is the option to make good -- to whatever degree they wish -- the losses that depositors might otherwise suffer.

This option and the parallel option to suspend formal insurance limits make it less important than taxpayers generally suppose whether or not a <u>formal</u> insurance <u>fund</u> has been established or whether insurance <u>coverage</u> under that fund is limited to a specific maximum amount. In recent American state and federal insurance debacles, many knowledgeable depositors knew for years that the fund of insurance reserves supporting their deposits was inadequate. In maintaining or increasing their deposits, these informed depositors speculated that, if a depositor run or supervisory action were to reveal the fund's inadequacy, incumbent politicians would find it in their collective self-interest to bail out all or most of the shortage. The riskiness of this speculation and decapitalized institutions' eagerness to expand their risky investments explain the substantial interest premiums that tend to develop on a Ponzi firm's deposits.

The key feature in shifting liability to taxpayers for part of Farrow's losses was the incompleteness of arrangements for funding implicit state deposit insurance (Kane, 1990). This incompleteness allowed incumbent politicians to avoid informing taxpayers, as the Farrow institutions became increasingly undercapitalized, that they were almost certainly on the hook for depositor losses until they found it necessary to do so. Hence, an implicit "completing" and taxpayer-financed fund of contingent reserves may be said to exist whether or not a nonzero explicit client-institution-supported deposit-insurance scheme also exists. Markets value this completing fund and implicitly assign it to taxpayers because economic forces are expected to act on politicians in predictable ways.

The credit enhancements that this completing fund creates for troubled banks and thrift institutions may be characterized as implicit deposit insurance. Even in the absence of an explicit deposit-insurance fund, the actions of deposit-institution supervisors determine a trajectory over time for the completing deposit-insurance reserve fund that taxpayers supply. The value of this fund can and should be controlled by subjecting deposit institutions to nondiscretionary regulatory discipline that escalate predictably as their enterprise-contributed capital shrinks (Shadow Financial Regulatory Committee, 1989). Taxpayers' positions needs to be measured regularly and reported publicly. Only in this way can regulators' performance in controlling taxpayer loss exposure be monitored in timely fashion under any institutional structure.

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TABLE 1

CHRONOLOGY OF FARROW BUILDING-SOCIETY DISASTER
DECEMBER, 1990

1. Loss Generation Fostered by Continued Regulatory Forbearance

June 30, 1983	Farrow Corporation embarks on rapid-growth strategy for what it later calls its Geelong Building Societies Group. Moves from A$260 million in assets to A$600 million in three years.
1986 Audit	In their confidential report to management, the Farrow Group's accountants are said to have cited dangers in the Group's financial practices. Practices include booking high levels of upfront lending fees (a Ponzi-like procedure for pumping up accounting profit to support unreasonable dividends and management fees) and potentially illegal heavy concentrations in commercial mortgage lending.
June 30, 1988	Farrow Group has A$1.1 billion in assets.
December 31, 1989	Farrow Group has A$2.9 billion in assets, which represents about 55 percent of the Victoria building society sector and about 16 percent of national sector.

2. Rational Depositor Testing of the Resources Left in Failing Firms

February 13, 1990	To stop a 3-day A$200 million run on Pyramid, State of Victoria Treasurer, Rob Jolly, gives vote of confidence to Pyramid after he allegedly "checked the matter out". At the behest of Pyramid's directors, he relies on statements from the firm's auditors and the State Registrar of Building Societies to assure depositors that they had "absolutely no reason to be concerned". Run slows greatly, but net withdrawals continue until the institution is closed in June.
May 4, 1990	Citing prudential concerns, New South Wales (NSW) regulators reject application

by Pyramid to expand its building society operations into their state. Net withdrawals subsequently accelerate.

3. Open Bureaucratic Breakdown

June 22, 1990	State of Victoria takes control of Farrow's Pyramid and Geelong Building Societies. It appoints a Cooper & Lybrand's partner, Mr. Ken Russell, to serve as Administrator. Mr. Russell initially supports Farrow contention that its run is based on groundless rumors. Attributes government takeover to "an unwarranted and long-sustained run on these societies which commenced in February 1990, resulting in an unacceptable drop in liquidity levels." Book value of Farrow assets has declined to A$2.5 billion. Although at least 50 percent of a building society's assets are supposed to be lent out for "residential purposes" and mortgage-backed certificates, 88 percent of Farrow's turn out to be commercial mortgages.
June 24, 1990	Operations are suspended at all Farrow Group building societies. All accounts are frozen.
June 25, 1990	Victoria premier, John Cain, signals the government's unwillingness to bail out Farrow depositors, claiming "no moral obligation" to underwrite the activities of a "private-sector corporation".
July 2, 1990	Lawyer F. Galbally promises to proceed with a class-action lawsuit on behalf of Farrow depositors against the State of Victoria and its individual ministers for "negligent misstatement".

4. Depositor Bailout and Loss Redistribution

July 3, 1990	After previously denying that it would offer a bailout, the Victoria government guarantees A$1.3 billion in unsecured deposits, but leaves terms of bailout vague.

July 23, 1990	Administrator of Farrow Group announces his inability to sell off Farrow assets in a whole-bank bidding framework. ANZ Bank had been exploring an acquisition of the Farrow Group for some months.
August 7, 1990	Coopers & Lybrand estimates that 80 percent of book value can be recovered by liquidating Farrow assets. It measures the Farrow Group's deficiency at A$400 million to operate as a going concern and A$250 million in liquidation.
October 9, 1990	Based on an independent consultants' report, State of Victoria Attorney General Kennan characterizes mismanagement and excessively speculative activities as the cause of Pyramid's collapse. He indicates that Farrow losses could range up to A$569 million.
October 30, 1990	Depositor payment plan is adopted to unfreeze accounts. It eliminates accruals of interest after June 30, 1989, and denies rights of offset to depositors who are also mortgagors. Accounts under A$100 were paid in full in August. Other depositors had been offered a 25% payment in August 1990, with the other 75% strung out (using a sliding scale based on deposit size) in noninterest-bearing 5-year promissory notes to be issued in mid-December, 1990. (In June 1991, the market value of representative bonds stood at about 60 percent of their face.) Although accepting depositors retain the right to any "liquidation profits" that the state might realize, to receive the notes a depositor had to waive his right to sue for a larger recovery than is realized by the liquidators.
December 1, 1990	A 3 cents per liter petrol tax goes on line to finance the bailout. Informed observers see this as a measure reducing the state's general deficit. Given the haircut imposed on large depositors, the yield of this tax will exceed bailout costs by many A$ millions per year.

5. Blame Redistribution

October 11, 1990 — Opposition accuses Kennan of editing out of the "independent" consultants' report on Farrow details of government intervention to protect political careers. One backbencher from Geelong acknowledges an effort to keep the societies open in response to a mid-June visit to his office by Farrow.

December 12, 1990 — Liquidation of Farrow Group is Announced. Administrator Russell is required to hand over control of the Farrow assets to a provisional liquidator, accountant Tony Hodgson. A suit on behalf of holders of nonwithdrawable shares in the failed building societies is to proceed against former-Treasurer Jolly and Victoria Planning and Urban Growth Minister, Mr. McCutcheon. The suit characterizes as "negligence and deceptive conduct" these officials' February 1990 assurances that funds invested in the Farrow Group were secure.

Sources: Pyramid and Farrow Annual Reports; press coverage in The Australian, The Age, Geelong Advertiser, and Australian Business: Parliamentary Debates (Hansard), Parliament of Victoria.

Note: The Farrow Group consisted of the Pyramid, Countrywide, and Geelong building societies, plus the Commercial Credit Co-operative, Ltd. The chief subsidiary was Pyramid, which itself owned the Federation Building Society and about nine other financial-services subsidiaries. At about the same time, at least one other Victoria financial institution, the small Premier Friendly Society, also collapsed.